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## VIA FACSIMILE AND EXPRESS DELIVERY

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Re: *Further Supplementary Proposed Rule - Establishing Oil Value  
Due on Federal Leases*

Dear Mr. Guzy:

Texaco Inc., on behalf of itself and its affiliates, including Texaco Exploration and Production Inc. ("TEPI"), submits these comments on the Further Supplementary Proposed Rule for Establishing Oil Value for Royalty Due on Federal Leases, published in the Federal Register on July 16, 1998 (63 Fed. Reg. 38355). We also wish to comment on the "MMS Responses to Industry Recommended Improvements" to the proposed regulations, which was published on July 24, 1998. Texaco urges MMS to continue to allow lessees to use a tendering procedure, such as that used for the last several years by TEPI and described in Texaco's earlier comments, as an option to establish oil value for royalty purposes. If MMS declines to continue to allow tendering in its new rule, then Texaco urges MMS to take its royalties in kind whenever lease values are questioned. Of course, we stand ready to assist MMS in its efforts to clarify or to improve methods to determine values of crude oil at the lease.

Texaco has actively participated in the rulemaking process by submitting extensive comments and suggesting alternative valuation methodologies in response to the January 1997 proposal, the September 1997 Notice of Reopening of the Public Comment Period, and the February 6, 1998 Supplementary Proposed Rule for Establishing Oil Value for Royalty Due on Federal Leases. Texaco representatives have attended public hearings on the rulemaking, including the recent July 9 and July 22, 1998 meetings with MMS and industry representatives.



36 USC 380

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David S. Guzy  
July 31, 1998  
Page 2

and Members of Congress. MMS in its further supplementary proposal seeks comments on changes to four discrete areas of the prior proposals. Regrettably, MMS to date has not addressed the bulk of Texaco's prior comments on the proposed rule. The current supplement makes some minor changes that we endorse, but does not address the principal legal and serious practical issues we have raised. We respond below to the issues raised by the further supplementary proposal in the order they appear in the Federal Register notice. Where relevant, we also incorporate comments to the July 24 MMS "Response" document.

#### **I. PROPOSED RETENTION OF THE DEFINITION OF "AFFILIATE" IN THE CURRENT REGULATIONS**

Texaco supports elimination of the Second Supplementary Proposed Rule's *irrebuttable* presumption that 10 percent ownership gives a lessee *control* of an "affiliate," which would require transactions between the two to be valued using proposed non-arm's-length criteria. *See* 63 Fed. Reg. at 6126. The new proposal would retain the *rebuttable* 10 percent presumption in the current rule. 30 C.F.R. § 206.101. However, Texaco believes that the 10 percent threshold is unreasonable in the context of the current rulemaking. Given the greatly expanded impact of the proposed rule on affiliates, and the diversity of ownership, partnership and joint venture arrangements entered into by federal lessees, the 10 percent threshold creating a presumption of control is arbitrarily low. The rebuttable presumption threshold should be elevated to at least a 20 percent level that is used by other federal agencies in analogous situations.

For example, Bureau of Land Management ("BLM") regulations regarding transfers of interests in coal leases create a rebuttable presumption of common control when two entities share at least a 20 percent common ownership interest. 43 C.F.R. § 3400.0-5(tr)(3)(ii). For purposes of consistency within the Department of the Interior, MMS must adopt the 20 percent threshold used by BLM. The Department of Commerce similarly uses a 20 percent common ownership interest test to determine whether a United States importer is "related to" a foreign exporter such that the price paid for the imported product may be suspect. *See* 19 U.S.C. § 1677(13). If the two entities are found to be in a 20 percent common ownership situation and the Department is not satisfied that the transaction occurred at arm's-length for purposes of assessing anti-dumping duties, the Department would presume to use the price at which merchandise is sold in the United States to an unrelated purchaser. *See* 19 U.S.C. §§ 1673, 1677(13), 1677a; *see also* *Queen's Flowers de Colombia, et al v. United States*, 981 F. Supp. 617, 624 & n4 (C.I.T. 1997); *Koyo Seiko Co., Ltd v. United States*, 92 F.3d 1162, 1166 (Fed. Cir. 1996). Of course, even a company that owns 50 percent of an affiliate may not exercise control over that entity. *See* *Public Svc. Co. of New Mexico v. FERC*, 832 F.2d 1201, 1213 (10<sup>th</sup> Cir. 1987) (citing *Public Svc. Co. v. FERC*, 628 F.3d 1267 (10<sup>th</sup> Cir. 1980), *cert. denied*, 451 U.S. 907 (1981)) (upholding FERC's determination that a price paid for coal by an affiliate could be used for determining electric power sales rates).

David S. Guzy  
July 31, 1998  
Page 3

There are substantial practical reasons why MMS should adopt a threshold ownership percentage in its definition of "affiliate" comporting with that used by BLM, Commerce and other federal agencies, *i.e.*, 20 percent or more. For example, the presumption that 10 percent common ownership gives an owner control of an affiliate would tend to eliminate legitimate arm's-length transactions from consideration under the gross proceeds valuation rules. MMS's stated goal in defining "affiliate" is to allow arm's-length, gross proceeds valuation to apply to transactions in which the participants have opposing economic interests. *See* 53 Fed. Reg. at 1193. As demonstrated by the plethora of statutory and regulatory schemes that employ a 20 percent ownership interest threshold for determining affiliate status, including that employed by the Department of Commerce to determine the validity of import prices, a 10 percent common ownership threshold is too insignificant to establish a presumption of non-arm's-length dealings.

## **II. "CLARIFICATION" OF PROVISIONS RELATING TO THE EFFECT OF A LESSEE'S BREACH OF ITS DUTY TO MARKET**

In the Further Supplementary Proposed Rule, MMS attempts to clarify its proposal to impose by rule "a duty" of the lessee to market production at no cost to the lessor. 63 Fed. Reg. at 38356; *see also* 30 C.F.R. § 206.102(b)(1)(iii). Texaco appreciates MMS's attempt to limit the situations in which it will rely on this provision to those where a lessee has entered into a "substantially below-market transaction for the purposes of reducing royalty," 63 Fed. Reg. at 38356. However, such assurances do not address the concerns raised by Texaco's previous comments that no duty to market downstream from the lease at no cost to the lessor can lawfully be imposed. Limiting the situations in which MMS would be able to exercise its right to second-guess a lessee's marketing decisions is not a sufficient safeguard for lessees when combined with MMS's erroneous view that a lessee has a duty to market production away from the lease. MMS's proposal offers no assurance that it will not someday assert that a lessee's arm's-length sale at the lease is a "substantially below-market transaction" because prices considered by MMS to be "substantially" better due to value added by the lessee might be available in a downstream market.

MMS's proposed deductions from downstream sales prices clearly demonstrate the inadequacy of these assurances. In its comments accompanying the supplementary proposed rule, MMS justifies its failure to subtract the value of downstream assets and services from the royalty base (which MMS characterizes as the "costs of marketing production") by asserting that "[t]he lease requires the lessee to market production at no cost to the lessor." 63 Fed. Reg. 6120. MMS further contends wrongly that the "Interior Board of Land Appeals has consistently upheld MMS on this position," and that MMS is not, therefore, proposing to alter "its long standing policy." *Id.* As explained in Texaco's comments to the Second Supplementary Proposed Rule, MMS is wrong on all points.

None of Texaco's federal oil and gas leases contains any requirement that the lessee market lease production away from the lease at no cost to the lessor. Instead, the leases provide

David S. Guzy  
July 31, 1998  
Page 4

for royalties to be calculated based on value at the lease. The IBLA has never held that a lessee must market production off the lease at no cost to the lessor. Instead, the IBLA has made clear that value is to be determined at the lease. In *Xeno, Inc.*, involving gas valuation for example, the IBLA noted that its decision in *Beartooth Oil & Gas Co.* had been reversed in part because "the Board erred in applying the marketable condition rule without considering the conditions under which gas will be accepted by a purchaser under a sale contract typical for the field or area." 134 IBLA 172, 182 n.14 (1995)(emphasis added). The cases have consistently held that, if value at the lease must be calculated using a downstream price, then the lessor must bear the costs of transporting and marketing lease production away from the lease. See *Xeno, Inc.*, 134 IBLA at 180 ("When gas is valued at a point downstream from the wellhead where the value of production is ordinarily determined, allowances are generally required for the value added to the gas after production"). Federal court cases are in accord. See *Enron Oil & Gas Co. v. Lujan*, 978 F.2d 212, 215 n.3 (5th Cir. 1992)("the value of a unit of gas is equivalent to what a customer will pay"); *Diamond Shamrock Expl. Co. v. Hodel*, 853 F.2d 1159, 1165 (5th Cir. 1988)("It is obvious from a complete reading of all the relevant statutes, regulations, and lease provisions, that royalties are not due on 'value' or even 'market value' in the abstract, but only on the value of production saved, removed or sold from the leased property")(emphasis added); see also *Martin v. Glass*, 571 F. Supp. 1406, 1415 n.2 (N.D. Tex. 1983)("The lessee's obligation to market is to market at the well"). It follows, therefore, that even if situations existed where MMS could use a downstream resale price to value federal lease production, which is disfavored by the courts, it would need to subtract from that price the full value of downstream assets, services and risks.

Therefore, MMS's statement that it will reject a lessee's arm's-length sales prices only when they are "substantially below market" does not address Texaco's concerns. The "market" price MMS would use for comparison would have no relationship to market value at the lease.

### III. PROPOSED RETURN TO MMS'S EARLIER PROPOSAL REGARDING EXCHANGE AGREEMENTS

With respect to valuing crude oil subject to an exchange agreement, MMS received sharp criticism that its proposal requiring lessees to trace crude oil molecules to an ultimate arm's-length sale would be extremely burdensome, if not *impossible*, to comply with. Critics explained that once crude oil is commingled with other production, as is almost always the case, no reasonable way exists to distinguish between federal and non-federal oil or between federal oil from different fields or areas. Yet, MMS now responds to that reasoned criticism by substituting an earlier proposal that would require much of the same tracing of molecules. MMS's proposal to return to its July 3, 1997 exchange agreement proposal cannot be a feasible option because it again entails tracing obligations that as a practical matter are virtually impossible to implement.

Texaco, in particular, is a heavy purchaser of crude oil from third parties through its affiliate Equilon Enterprises, LLC, and much of that oil is commingled with federal and other crude prior to any exchange and resale in a downstream market. Even *attempting* to comply with

David S. Guzy  
July 31, 1998  
Page 5

a rule requiring tracing of federal lease production to a downstream resale transaction would be extremely difficult and costly. At a minimum, the proposal would substantially raise costs.

In response to renewed criticism of the latest proposal, MMS recently published a list of three "options," and requested that commentators "clearly state which options best reflect their position on this issue." (MMS Responses to Industry Recommended Improvements, July 22, 1998.) Yet all three "options" again involve tracing of crude oil molecules and, thus, present no real options at all. The "options" are: 1) tracing molecules if sold arm's-length after an initial exchange (the current proposal); (2) tracing molecules even in the event of multiple exchanges to an ultimate arm's-length sale (the former proposal); or (3) electing (with the election holding for a two-year period) either tracing in the event of multiple exchanges to an ultimate sale (#2 above) or using widely discredited downstream index pricing. Again, the "options" involving tracing of molecules make no sense and cannot reasonably be implemented. Thus, the three listed options are nothing more than a disguised attempt to force commentators to "choose" index pricing. For reasons fully stated in Texaco's previous comments, MMS's index pricing proposal is (1) unlawful, and (2) discriminatory, and cannot be viewed as a viable option. Again, Texaco proposes the option that lessees, whether involved in non-arm's-length sales or exchanges, should continue to be allowed to value oil using arm's-length prices received in a public auction -- i.e., a tendering program -- or other comparable arm's-length transactions in the field.

**A. Texaco's Further Comments to MMS's Recent Response  
Concerning Tendering Programs**

In its July 22, 1998 Response to Industry Recommended Improvements, MMS made several erroneous statements about proposed tendering programs that must for the record be corrected. MMS states: "Tendering is an artificially-created market for the purpose of paying royalties. It does not represent how companies actually market their production and accordingly cannot represent market value." This statement is completely wrong. As set forth in its prior comments, Texaco has engaged in tendering for three years. Tendering is how Texaco "actually" markets its production. Contrary to MMS assertions, tendering is the basis for valuation of TEPI's *entire production* covered in each market area, not just for the royalty component. In addition, other companies are now "actually" marketing their production through a tendering program. Generally, producers' performance is measured by the sale of this production at the highest price possible. Tendering did not create an "artificial" market at the lease. If anything, it has enhanced competition in an established market.

Of course, the statement that tendering "cannot represent market value" is flatly inconsistent with MMS's own proposed use of tendering in the Rocky Mountain region. In any event, it is axiomatic, as a matter of basic economics, that an arm's-length public auction, which tendering represents, demonstrates "market value."

David S. Guzy  
July 31, 1998  
Page 6

MMS states that a tendering program would be unnecessary if a "truly" active market at the lease existed. In fact, as the irrefuted expert opinions and the only data in the public rulemaking record demonstrates, the market at the lease is active with many crude oil traders and other participants. This market is made even more active with a tendering program where crude oil is literally auctioned off to the highest bidder.

MMS states that "[t]endering is not a legitimate measure of value where it involves only small volumes . . . ." Of course, without a definition of "small volumes," this statement is difficult to respond to -- although the statement is particularly ironic given MMS's proposal to use spot market indices where volumes are completely *unknown* and surely often very small. Texaco has proposed tendering substantial, meaningful volumes of lease production. Unlike spot market volumes, tendered volumes are fully known and can be readily monitored. MMS is inappropriately preoccupied with the percentage of production that should be tendered when it should be concerned that market value is in fact established. By focusing on the wrong issue, MMS has overestimated what volumes are necessary to establish market value. In Texaco's experience since initiating the tendering program in 1995, 10-20% is more than sufficient to establish competitive prices.

MMS next states that tendering is not legitimate if production comes from "company-selected properties." MMS later complains that "[u]nder existing tendering programs, companies do not tender from *every lease* in a particular field or area but use the price received from those leases from which they do tender to value production sold to an affiliate from all their leases in a field or area." *Never* has MMS (or anyone else that we know of) *ever* suggested that arm's-length prices need to be derived from "every lease," as distinguished from every field or area in which one or more leases are located. Texaco has developed a procedure that ensures all volumes in the bid area are comparable from a pricing standpoint. Under the MMS rationale, it is possible that some leases with very small volumes would not be commercially attractive to all bidders because of the administrative cost of a lease-by-lease transaction. Aggregating leases into efficient marketing packages and tendering an appropriate volume from the package ensures the highest price.

#### **B. Texaco's Comments on Other MMS Responses in the July 24, 1998 Document**

MMS's July 24, 1998 Response reiterates that MMS seeks "to ensure the public receives fair market value for its oil; to eliminate reliance on posted prices; to simplify royalty reporting, payment, collection and auditing; and to provide certainty for both royalty payors and government." Yet, while claiming to seek a fair market value for oil, MMS has ignored its legal obligation to use values *at the lease* and not at locations far removed from the lease. As to "reliance on posted prices," no commentator that we are aware of is even suggesting continued reliance on posted prices. With respect to "simplify[ing] royalty reporting," Texaco's and other's comments have made clear that MMS's proposed rule would greatly complicate royalty reporting

David S. Guzy  
July 31, 1998  
Page 7

and impose huge additional costs. Again, the data supporting these comments are irrefuted in the rulemaking record. As to providing "certainty," those comments also show that using locations remote from the lease to value oil production creates tremendous uncertainty and discourages efficient use of resources.

### **1. *Menu***

MMS objects to allowing companies to choose among valuation procedures described in any new regulation because it would likely result in undervaluation and increase complexities. Yet the so-called "menu" proposal provides that once a procedure is chosen, a company must stay with it for a several-year time period. As such, "gaming" to decrease royalty payments would not be possible under this proposal. Instead, the menu proposal allows different companies having vastly different resources, *e.g.*, computer systems in place, administrative support groups, marketing resources, etc., to choose the more efficient of the MMS-approved valuation methods that would fit their business capabilities. In Texaco's experience, tendering is less administratively burdensome than an index or other netback methodology that would require difficult, if not impossible, allocations, tracking, reports and procedures. Because the administrative burden of each option will vary greatly from producer to producer, Texaco supports the menu option.

### **2. *Comparable Arm's-Length Transactions***

MMS claims that its audits have found very little federal oil sold at arm's-length. Texaco has no access to the referenced MMS audits, but this statement is fully contradicted by the only expert data in the administrative record, which shows an active market at lease levels. With respect to Texaco, the last completed audit by MMS covered 1989 to mid 1992. MMS's current audit begins in 1992 and ends in 1995. As a matter of law, a rulemaking should be based on current, relevant information. Texaco asserts that data extracted from such vintage audits referenced by MMS does not reflect current market conditions.

MMS asserts that "we have found the application of comparable arm's-length criteria to be costly and difficult to administer." Yet the uncontradicted public record shows that the new MMS proposals would be hugely more costly and difficult to administer than the current rules. MMS offers no comment as to why a tendering program such as that used by Texaco would be either costly or difficult to administer.

### **3. *Duty to Market***

(See comments in section II above showing that MMS cannot lawfully require a lessee to market crude oil off the lease at no cost to the lessor.) The relevant case law clearly refutes MMS's position. MMS has cited no authority supporting its position that an allowance for marketing costs incurred in a downstream market has been disallowed or is improper. Indeed,

David S. Guzy

July 31, 1998

Page 8

until recently, no one was seriously proposing that crude oil be marketed in a location remote from the lease at no cost to the lessee.

#### **4. *Third Party Rate or Comparable Costs of Service Rates***

MMS asserts that its audits have found that "very little" oil is transported at arm's-length. Texaco routinely uses third party arm's-length transportation services to move portions of its production. The use of third party arm's-length transportation services is a common practice, not only by Texaco, but by others in the industry.

#### **5. *Non-Binding Guidance***

In response to suggestions that MMS maintain a process by which lessees can procure binding valuation determinations, MMS responds that only the Assistant Secretary, if requested, may issue binding valuation determinations. MMS should realize that, given the enormous complexities and uncertainties its proposed rule would create, the Assistant Secretary would be deluged by requests. For example, lessees would have no reasonable way of knowing how MMS would view an allocation scheme dictated by an attempt to trace federal production to a downstream transaction. Without binding valuation determinations the proposals would lead to a litigation nightmare. MMS's suggestions that Congress might intervene may be well taken under the circumstances.

### **IV. GATHERING AND TRANSPORTATION**

Finally, Texaco believes that the definition of gathering should at least be modified to address the situation described in the further supplementary proposal, *i.e.*, the movement of production from sub-sea production facilities over long distances before reaching an offshore platform. Sub-sea development, with wells completed on the sea floor, is made possible by new technology and was not considered when "gathering" was defined in the 1988 regulations. Production from various sub-sea wells flows many many miles further than that of traditional gathering systems before reaching a platform. At a far-away platform, production is treated and then moved to shore with other offshore production. Movement at great distances from a sub-sea manifold to a production-treating platform should be classified as transportation and not gathering. As they stand, the regulations would punish users of sub-sea technology if this form of transportation were classified as "gathering." Unlike traditional gathering systems, sub-sea development thus entails moving crude oil off the lease over large distances nearer to shore and nearer to a market center where crude oil is more valuable. Under the circumstances, an adjustment for fair value of transportation services is merited.

As producers on the Outer Continental Shelf move into deeper and deeper waters to drill for crude oil, investment in underwater pipelines will increase dramatically. The sub sea investment levels are much higher than those contemplated for crude oil fields when the original

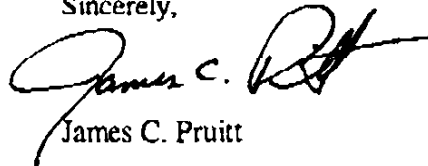
David S. Guzy  
July 31, 1998  
Page 9

definition of "gathering" was drafted. MMS should address this increasingly relevant issue by allowing lessees to deduct these costs for deepwater wells.

## V. CONCLUSION

Texaco urges MMS to withdraw the Further Supplementary Proposed Rule for Establishing Oil Value for Royalty Due on Federal Leases, and the related Supplementary Proposed Rule for Establishing Oil Value for Royalty Due on Federal Leases. The Further Supplementary Proposed Rule does not solve the principal problems raised by prior comments. Texaco again urges MMS to continue allowing use of a tendering program, like that utilized by TEPI and described in Texaco's earlier comments, as an option to establish oil value for royalty due on federal leases. Again, if MMS declines to adopt a tendering program, then Texaco urges MMS to take its royalty in kind whenever lease values are questioned. Furthermore, any final rule should revise the definition of gathering to take into account the changing nature of offshore production and to permit lessees to receive a reasonable return on their investment in deepwater production. We would be pleased to provide any further assistance to MMS in its consideration of the proposed rule.

Sincerely,



James C. Pruitt